Stop the Presses!

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“If Trump wins, I’m leaving the country. If Hillary wins, I’m leaving the country. This is not a political post; I just want to travel.”
-ANONYMOUS

INTRODUCTION

Stop the presses! Writing a weekly newsletter is an interesting exercise in time-management, especially when it isn’t your real “day job”. Because I am primarily focused on my role as Evergreen’s chief investment officer, my coping strategy is to typically get a head-start on writing our EVAs, creating most of the content, at least in rough form, over the prior weekend.

Alas, most of what I had produced for this week’s issue, under the assumption that Hillary Clinton would be the 45th president, became obsolete as of about 11 P.M. on Tuesday night, west coast time. This was intended to be a Random Thoughts EVA, touching on the election but mostly focused on economic and financial trends that were likely to stay largely on their current path had Mrs. Clinton won. Obviously, conditions have changed dramatically. Consequently, the Evergreen team felt we should address the new environment immediately. We also felt you would want to see the views of our partners at Gavekal. First, though, let me attempt to outline what Evergreen feels are the key opportunities and risks created by this political head-spinner.

Wrong, wrong, and, wrong. As I admitted above, I was playing the heavy odds in favor of Mrs. Clinton in my choice of subject material. Yet, it wasn’t because of the polls or even the betting odds. There have been enough examples lately of wildly inaccurate polls—including Brexit, the peace treaty in Colombia, and several other recent elections/referendums—that I didn’t have a lot of confidence in the polling or the so-called betting-line. Rather, it seemed improbable to me that Mr. Trump could win while losing the Latino vote, the black vote, the young adult vote, the female vote, the urban vote, the west coast vote, and the east coast vote. To my simple mind, it seemed like a huge leap of faith that he could win the popular vote without carrying any of those population segments. And, actually, as the latest tabulation indicates, he didn’t. Nevertheless, that was my mistake number one.

(It’s also incredible that Mr. Trump pulled this off by getting 2 million fewer votes than Mitt Romney did in his trouncing by President Obama four years ago. Maybe all those voter cohorts I rattled off earlier believed the polls and decided it wasn’t necessary to actually go vote for Mrs. Clinton. If so, that was a really big mistake!)

Boo-boo number two was believing the electoral college experts who opined that even if Mr. Trump did eke out a win in the popular vote, the electoral path to his victory was much more daunting. Obviously, that turned out not to be the case, apparently due to the fact that several certain-to-be-blue states turned red after all, generating an electoral wind-fall for Mr. Trump. This was another huge miss by the political forecasting community.

My third mistake was believing that, based on the market’s mild but persistent sell-off since FBI director Comey’s letter to Congress reignited Ms. Clinton’s email controversy, a Trump victory would slam the market should it happen. My conviction in that was strengthened on Tuesday evening as the stock market fell further every time another state was declared for Mr. Trump. At one point, the Dow was down roughly 800 points in overnight futures trading.

Based on those two realities, my team and I came charging in on Wednesday morning ready to buy. We were particularly interested in adding to our energy infrastructure (i.e., pipeline) holdings, believing they would be beneficiaries of Trump's pro-energy development platform. This belief was further intensified by Congress remaining under GOP control. Accordingly, we thought any knee-jerk sell-off by the pipelines (MLPs) would be an outstanding buying opportunity.

Another oops! The stock market opened essentially unchanged and MLPs actually traded up from the get-go. Instead of taking a major chomp, we ended up nibbling a bit under the thesis that they had previously retreated about 12%.

Despite the logic of the high hurdles Mr. Trump needed to overcome, we were tracking what Charles Gave was saying about the potential for "the man with orange hair" to pull off an upset. Just last week Charles wrote in an internal email: "Dear all, I am starting to believe that Trump is going to be elected." Louis Gave also authored a Gavekal piece on Monday stating that a Trump win was much more likely than the odds given by most political experts.

Clearly, Charles and Louis were much more in tune with the mood of the electorate than the professional political pundits. In their minds—and mine—the Trump upset is an extension of the Bernie Sanders phenomenon, as well as other populist political uprisings occurring throughout the developed world. Within our country, I believe these anti-establishment movements vindicate my oft-stated belief in these pages that this economic up-cycle has been much more about inflated asset prices, which have benefited the wealthy (at least for now) versus raising living standards for middle-America.

But, as always for us, it's about the investment implications. Despite Wednesday's remarkable stock market reversal, we believe a Trump presidency is a mix of pros and cons, as we outline below:

Potential Positives	Potential Negatives
A truce in the war by the government on the private sector	Rising interest rates
Regulatory right-sizing	End of the Fed's "Big Easy" pol
Comprehensive tax-reform for both business and individuals	A trade war
Tax breaks for repatriating overseas profits	Exploding federal deficits
Another up-leg in the bull market	Higer inflation
Confidence boost for small businesses	Even greater partisan animosi

Based on the market's reaction to Mr. Trump's election, it seems like the consensus view is that it's time to sell bonds and buy stocks, especially those of a cyclical nature. When it comes to energy, we can buy that (literally!). We also concede that both the market and the economy can withstand some increase in rates. But realize the 10-year treasury is already up from 1.3% in July to over 2% today. Yields are also rising all over the world. The central bank-engineered environment of interest rate eradication has been a huge prop for stock prices. Taking that away has an immediate impact, whereas a number of the positives above will evolve slowly, over the years, if at all.

Many have pointed out the eerie similarities between the unlikely political successes of Ronald Reagan and Donald Trump—despite the fact that Mr. Trump lacks the grandfatherly warmth of our 40th president. But it's easy to forget that the early years of Mr. Reagan's administration were very painful, both in the economy and the financial markets, as he sought to get inflation under control (with a monster assist from Paul Volcker). Mr. Trump doesn't have high consumer inflation to deal with as President Reagan did. But he sure does have a lot of asset inflation to be mindful of, as he attempts to make the shift from policies that benefit Wall Street to those that help all of the angry Main Street voters who came out for him in droves.

Despite the current sudden euphoria about future growth prospects, we'd suggest keeping a wary eye on how much damage the bond market incurs. 1987 showed us, during the height of the Reagan boom, what can happen when bond yields go postal.

Now, let's hear what two of Gavekal's senior partners have to say about the new era in American politics.

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WHEN ELITES FAIL

By Louis Gave

The most timeless analysis of American political culture was provided by Alexis de Tocqueville, who wrote the following of American democracy:

> "The election becomes the greatest and, as it were, the only matter which occupies people's minds. Then political factions redouble their enthusiasm; every possible phony passion that the imagination can conceive in a contented and peaceful country comes out into the light of day… As the election draws near, intrigues multiply and turmoil spreads. Citizens divide up between several camps each of which adopts the name of its candidate. The whole nation descends into a feverish state; the election becomes the daily theme of newspapers, the subject of private conversations, the object of every maneuver and every thought, the only concern of the present moment. It is true that as soon as the result has been announced, this passion is dispelled, all returns to calm, and the river which momentarily overflowed its banks returns peacefully to its bed."

Now the Burkean conservative in me wants to agree with de Tocqueville: the passions unleashed by this election will hopefully once again, go back into their box for the next three and half years, only to be stirred up again the next time the electoral cycle comes around. Still, there are two elements of this week's vote that do raise discomfort.

1) Back in 2004, John Kerry had made the theme of his campaign the problem with the "Two Americas". And of course, back then Kerry referred to the rich and the poor. But this vote illustrates that the US really is dividing into two countries as the gulf in voting patterns widens along income, education, gender, class, and urban/rural divides. Increasingly, Americans seem to live in self-reinforcing echo-chambers where they solely interact with people who hold the same beliefs and values. Combine this new reality with the news filtering capacity provided by social media algorithms and it is clear that growing parts of the country will never have to confront uncomfortable facts, or opinions. Illustrating this is the fact that, while a generation ago, the median US congressman was elected by a margin of less than five percentage points, once again in this election the median US congressman will be elected by a sizeable double digit margin. This cannot be a healthy development.

2) However one cuts it, the unique feature of the 2016 election has been the rise of the populist vote; Bernie Sanders' insurgency was by far the best a red-blooded Socialist candidate has done in any big western democracy in recent years. Donald Trump's solutions to the challenges confronting our societies are broadly in line with those offered by France's National Front. Although, not even Marine Le Pen would dare propose a ban on Muslims entering France! Clearly, we have entered a new era where domestic discontent, not just in the US but across the Western World, is sky high. And behind this discontent sit factors such as technological disruption, dislocations caused by the ascent of emerging economies as industrial powers, the ageing of Western societies and the shift that immigration has caused to the cultural make-up in these countries. And this brings us to the timeless observation by Arnold Toynbee who, in *A Study of History* argued that the role of an "elite" in any society is to handle challenges that allow the group to survive and so move on to the next phase of their shared journey. If bad solutions are offered up then problems intensify and rising pressures eventually trigger a change in the elite. This can happen in various ways. Needless to say, elections are by far the best case

scenario (no bloodshed or destruction of property). But if elections do not trigger the required changes (e.g. France during the Fourth Republic and the challenge of decolonization), then this can engender a change of regime (a distinct possibility across euro-land?), or even revolutions. Judging by Donald Trump's likely win in the US presidential race, it would seem that the US for its part does not believe that political dynasties should be left to solve the country's problems. Looking forward, the hope must be that the new president will rise to the huge challenges facing the US and the wider world with genuine solutions to real problems.

But I am doubtful, which is why we prefer countries and markets that have the advantage of small scale as entrenched interests tend to run less deep and finding common ground for the "shared journey" is politically easier. It is also why we prefer overweighting countries with the Queen's head* on the bank note (and as a Frenchman, it really hurts to say this!).

*I.E., Canada, Australia, New Zealand

WHAT A TRUMP PRESIDENCY MEANS FOR GLOBAL INVESTORS

By Anatole Kaletsky

The social and geopolitical implications of the Trump shock are much too complex and too charged with emotion for instant assessments to be worthwhile. Even in the case of ordinary presidential elections, the immediate first-day market reaction usually turns out to be wrong. I will therefore try to avoid moral judgements and confine myself largely to economic observations, dividing them into ten items of good and bad news from a strictly financial point of view.

First, the good news:

Economic growth and fiscal stimulus. The US economy will grow faster in the first two years of Trump's presidency than the average rate established in the eight years of Obama. And the new Republican ascendancy will try hard to avoid a recession ahead of the 2020 presidential election, with plenty of assistance from a more politicized Federal Reserve chair. This growth acceleration will be achieved by cutting taxes and ramping up public spending, especially on infrastructure and defense and probably also on healthcare. Whether the resulting budget deficits are viewed as Keynesian fiscal stimulus or Reagan-style supply-side economics is of little interest: their impact will be to increase both real economic activity and inflation. As the Trump presidency progresses and the US economy runs up against the limits of full employment, additional nominal growth will probably come through inflation rather than real economic activity, but will still be positive for corporate revenue top lines.

Tax reform. Tax reforms that should have been implemented years ago, such as a partial amnesty for repatriated profits, will finally become possible. But revenue-neutral simplifications of the tax code, resulting in lower tax rates on a broader base are less likely, since powerful business interests will resist them. Instead, corporate tax cuts will probably be financed simply by running larger deficits. These deficits may be optically eliminated in ten-year budget plans simply by assuming positive supply-side effects and stronger economic growth through "dynamic scoring". And wider budget deficits will in fact produce faster growth for the next year or two, followed by higher inflation from 2018 onwards.

Deregulation. Environment and energy regulations will surely be weakened but Trump's attitude to labor regulation is less clear. It is hard to see how Trump's new Republicans will deliver on their promises of higher wages, especially for once-unionized industrial workers, unless they actually tighten labor regulations and raise minimum wages aggressively (following California). Of course, Trump could simply forget about his promises of higher wages for Midwest blue-collar workers. But that would be a big political risk now that the Republicans have hegemony at both the federal and state levels, and therefore no excuse for failing to deliver on their most important promises.

Geopolitics. The most surprising effect of the Trump presidency could be an outbreak of peace in Eastern Europe and the Middle East, and maybe also better, or at least more stable, security relationships with China. The explanation is simple. By pursuing purely transactional relationships with Russia and China—and by abandoning Obama's "liberal interventionist" support for democratic popular movements—the Trump administration should find it easier to stabilize the world's most troubled regions by establishing "spheres of influence". Russia could be given a much freer rein in Ukraine, Syria and Iran, in exchange for full-scale cooperation in suppressing Islamic terrorism and non-interference with NATO members in Central and Western Europe. China could be left to manage its territorial differences with other Asian countries, on condition that it does not resort to outright war. The biggest geopolitical uncertainty may be relations with Israel, Iran and Saudi Arabia, but Trump seems more willing than any previous American leader to pinpoint Saudi fundamentalism as the main source of the global Islamist threat. The logic of this position would be to show more tolerance for Iran's regional ambitions, in exchange for optically tougher enforcement of the nuclear agreement (alongside Russia and China) and at least a tacit agreement from the Ayatollahs to start defusing relations with Israel (something that Benjamin Netanyahu would also welcome if the terms were right).

Now the bad news:

World trade. The US now has a president with an overtly protectionist economic philosophy for the first time since 1930, when Herbert Hoover (reluctantly) signed the Smoot-Hawley Tariff Act. It is unlikely that Trump will fully implement his campaign promises to impose a 45% tariff on imports from China, the 35% tax on car imports from Mexico, US-content requirements on consumer electronics and so on. But the idea that Trump will make no substantial changes at all in US trade relations is wishful thinking. Trade curbs were among his most explicit commitments, and the main reason he managed to win the election by demolishing the Democrats' Midwest "firewall". If he fails to deliver on these promises, Trump will face a dangerous backlash from what is now the Republicans' core constituency. Even more importantly, Trump's record, his rhetoric, and his choice of economic advisers all suggest that he genuinely believes free trade to be a negative-sum game. Given that tariff setting is largely a presidential prerogative, not requiring Congressional approval, it is hard to understand the widespread assumption that US trade policy will not change very much.

If, as appears more likely, US economic philosophy now shifts from promoting free trade towards overt protectionism, this will constitute the biggest regime change in global economic management mechanisms since at least the early 1980s and arguably since the creation of the Bretton Woods institutions after World War II.

Monetary policy, inflation and bond yields. Assuming Trump goes ahead with his large scale tax cuts and public spending programs, the resulting fiscal stimulus and faster growth, in an economy already nearing full employment, will imply more aggressive Fed tightening or accelerating inflation, and probably a combination of both. The balance between higher inflation and higher short term rates is impossible to predict, but US bond yields seem certain to rise whatever happens. Factoring in the likelihood of some additional trade protectionism plus various forms of action to raise wages, including regulatory pressures against undocumented immigrant workers, the increase in interest rates and/or inflation looks quite substantial. That, in turn, will mean a steeper yield curve and major losses for bond investors, whether the Fed tightens fast enough to pre-empt inflation or not.

The US dollar. With monetary policy tightening quite aggressively, bond yields rising, and the US economy growing faster than expected, the dollar will probably start strengthening again, even though it is already overvalued, especially if Trump experiments with protectionist policies to narrow the US trade deficit. Once the dollar starts to strengthen this process could become dangerously self-reinforcing for two reasons. First, structural short positions in the US dollar among emerging market corporates and governments will be subject to forced liquidation. Second, the combination of faster US growth, dollar strength, and emerging market (EM) financial problems will recall the record-breaking dollar squeeze that occurred in the first four years of Reaganomics. This parallel may frighten dollar shorts, but it is one the Trump administration will be happy to endorse.

Emerging markets. The combination of a short squeeze in the dollar with a new protectionist paradigm for global economic management spells trouble for most emerging economies and EM assets. The obvious exceptions are Russia and perhaps some relatively closed economies that do not depend too heavily either on exports or on dollar funding. Brazil and India may be two such countries. But given the strong correlations between all EM assets, especially in bear markets, it is hard to be optimistic even about the EM countries that are not directly exposed to US trade or a dollar squeeze. Japanese banks, which have become the biggest lenders of US dollars to EM corporates, could also be badly hurt.

Europe. Europe does not have a dollar funding problem (with the partial exception of Britain's enormous current account deficit) but political contagion from the Trump election could have a dramatic impact on the EU and the euro. Just as the referendum in Britain turned out to be uncannily predictive of the Trump upheaval, Trump must surely be a leading indicator of political shocks in Europe in the year ahead. Brexit set a precedent for European disintegration and legitimized politicians in other countries that are calling for a breakup of the euro or the EU. Trump's election will immensely strengthen these disintegration pressures by convincing populist politicians and their supporters that history is on their side. Starting with the Italian referendum on December 4, then a Dutch election next March, the French election in May, and the German election in September, any one of these events could start an unravelling of the euro or the entire EU. And a euro crisis triggered by one of these elections (or all of them) would be far more damaging than the euro crisis of 2010-13. The financial speculation of the 2010-13 crisis could always be overcome by monetary policy. But political pressures for disintegration cannot be counteracted by the European Central Bank.

Investment environment. These observations point to several investment conclusions very different from the ones I drew in the expectation that US voters would opt for Hillary Clinton as the status quo candidate.

1) **US equities**, especially companies geared to the strength of US domestic growth, will perform better than non-US assets. But with Wall Street at an all-time high, profit margins near

record levels, the business cycle in its seventh year, wage pressures growing and bond yields rising, US equity prices already seem “priced for perfection”. US multinationals are certainly not priced for the greatest threat of protectionism and of the most unpredictable upheaval in global economic management in at least a generation.

2) **US bond yields** will rise sharply as monetary policy is tightened and US inflation accelerates.

3) The **US dollar** appreciation which I believed to be over by the end of last year will probably resume and could turn into a full scale dollar short squeeze in emerging markets.

4) **EM equities and bonds**, which would have been the best performing asset classes if Hillary Clinton had been elected are now among the most dangerous.

5) The EU looks likely to become the next site of major political upheavals, and these could prove critical or even terminal for the eurozone. As a result, **it will be dangerous to own euro assets**, at least until the political uncertainties begin to be resolved.

6) Rising US bond yields will result in **higher bond yields all over the world**, even though the ECB, Bank of Japan and Bank of England are sure to continue their zero interest rate and quantitative easing policies.

7) As investors reassess the world in the wake of the Trump shock, **US dollar cash, US domestic stocks, industrial commodities and inflation hedges** will be the most attractive assets, at least until the Trump administration’s attitudes to global trade and fiscal policy are clarified and the political uncertainties in Europe start to blow over.

OUR CURRENT LIKES AND DISLIKES

Changes are bolded below.

WE LIKE

- ge-cap growth (during a rection)
- ernational developed markets ring a correction)
- nadian REITs (take advantage of recent pull-back)
- rated corporate bonds (i.e., h-quality, high yield)
- h
- blicly-traded pipeline tnerships (MLPs) yielding 7%- %
- ermediate-term investment de corporate bonds, yielding proximately 4%
- d-mining stocks
- d
- ermediate municipal bonds with ong credit ratings
- ect blue chip oil stocks (on a l back)
- erging bond markets (dollar- sed or hedged); local currency in w select cases
- estment-grade floating rate porate bonds
- **xican stocks**

WE'RE NEUTRAL ON

- Most cyclical resource-based stocks
- Large-cap value
- Short-term investment grade corporate bonds
- High-quality preferred stocks yielding 6%
- Short yen ETF
- Emerging market bonds (local currency)
- Short euro ETF
- Bonds denominated in renminbi trading in Hong Kong (dim sum bonds)
- Canadian dollar-denominated bonds
- Long-term municipal bonds
- Mid-cap growth
- Long-term Treasury bonds
- Long-term investment grade corporate bonds
- Emerging stock markets, however a number of Asian developing markets, ex-India, appear undervalued
- The Indian stock market
- **Intermediate Treasury notes**
- **Select European banks**

WE DON'T LIKE

- US-based Real Estate Inve Trusts (REITs)
- Small-cap value
- Mid-cap value
- Small-cap growth
- Floating-rate bank debt (j
- Lower-rated junk bonds